Dairy Options Pilot Program Design Offers Farmers Opportunity To Set Floor Price

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and the government program is designed to help independent producers remain that way.

The DOPP program is not designed to guarantee producers a liveable income, but instead to teach a corps of farmers how to use the commodity trading marketplace to protect against losses.

The entire DOPP first meeting series was presented by a team representing the USDA RMA, the commodities trading industry, and the farming industry.

At the Lancaster Farm and Home Center meeting, the program was structured so that the morning session consisted of an explanation and overview of the DOPP program by USDA representatives.

The afternoon session began with a dairy farmer who already has been involved with trading contracts with the help of the USDA.

David Holzhauer of Meadow Spring Farm, an area dairy farmer, was selected in October 1997 to serve as a regional participant in a pre-program project. It was described as a mini-DOPP.

The pre-DOPP program was done in order to help establish peer experience, according to David Wiggins, regional service representative and an insurance management specialist with the USDA RMA.

Holzhauer's participation in the mini-DOPP was predicated on his agreeing to serve as a member of the team presenting the initial educational meetings in the full-DOPP.

Also on the afternoon slate of speakers was Jim Grahm, in charge of marketing for the Chicago Mercantile Exchange.

He explained the program basics and his outlook for dairy trading. Also, commodities trading industry representatives explained their system of contracts and trading.

A panel of brokers, who explained their services, responded to farmers' questions to end the day's educational session.

It was explained by USDA that for participating farmers, the DOPP is a one-time, six- to eight-month limited program that essentially provides cost-sharing funds to use "put" options available through the New York Coffee, Sugar and Cocoa Exchange and the Chicago Mercantile Exchange.

Both trading houses have offered dairy futures contracts and options contracts for several years with some success.

The DOPP program focuses on the use of "put" options; a trading contract that can be used by a farmer to lock-in a bottom price on certain weight of milk (100,000 pounds per contract at the CME), while not limiting his ability to receive higher market prices on the actual sale of his milk.

It's promoted as a form of insurance against severe drops in market price.

The way it works is that a dairy farmer, who knows that his monthly production (and thus his sale of milk) can be expected to be 100,000 pounds of milk (more or less), continues to sell his milk just as usual.

If he sells through a cooperative, for example, he continues to do that and receive his monthly milk check.

However, since the dairy farmer doesn't know how much he is going to get paid for that milk until after it is used, he is at high risk of losing money.

Lots of it.

The put option doesn't involve the sale of milk.

The put option involves the sale of risk.

For DOPP purposes, it is an offer by someone (risk taker) that, if he is paid a certain amount (the premium), he will pay out a certain amount if he isn't right that the USDA-announced BFP will not drop below a level set in the contract.

Someone who sells "put" options to farmers collects the premium money in exchange for the risk that he may have to pay out if the actual BFP price is less than what was projected in the put option contract.

The person who buys a put option risks the loss of the premium. (The level ranges, but generally less than $1 per hundredweight.)

The person who sells the put option risks having to pay out the full amount set in the put option.

For the farmer, the USDA considers the program to be risk management.

To understand the program, it is essential to understand what the federally determined Basic Formula Price (BFP) is, and how it is derived.

The USDA applies the formula, and help with understanding it should also be available through a local Extension office.

Given that the BFP is understood, a farmer has to know his cost of production and the relationship between the federally declared BFP and his milk check.

The difference between the two is the "basis."

If, for example, a farmer's cost of production is $12 per hundredweight, he may want to try to ensure he captures that amount in his actual paycheck, as a minimum.

Or he may decide to lock in at a lower level.

The reason to consider a lower level of lock-in has to do with the way the put options and the premiums are priced.

Futures traders can calculate and anticipate BFP fairly well, and are usually close to the actual USDA-declared BFP.

The premium price for a put option is based on the risk associated with the specific BFP price declared in the contract.

For example, if its January, and April BFP futures contracts seem to be settling around $12.50, a range of put option contracts are offered through the trading house reflecting that $12.50 BFP level, and several other levels, in 25-cent increments, up and down.

Therefore, a buyer of a put option has the ability to select a BFP put option based on the $12.50; as well as $12.75, $13, or $12.25, and $12.

The premium on the put option is what the farmer pays per hundredweight of milk volume to the seller of the put option.

For example, the premium for a put option at $12.50 may be 40-cents per hundredweight, and 30 cents for an option at $12.

The farmer considering purchasing a put option to protect his cash flow has to consider the factors that influence the price of milk and what the conditions are that affect those factors.

It's a guessing game.

If it seems that the BFP could drop by $1 or more per hundredweight below what the BFP futures traders are predicting through the price they establish through trading, then a dairy producer may want to figure out how much of a premium is reasonable to pay to lock in a put option at an acceptable level of return.

Those who participate in DOPP cannot use the government cost-share funds to purchase "put" options at prices higher than the projected basic formula price (BFP) at the time of the purchase of the option.

It works this way:

The futures market on BFP is set according to what traders consider will be the government-declared BFP for a given month. That amount changes with time and events.

For a dairy producer, the put options are paper-only contracts whereby he pays a premium to the right to sell his milk at a certain BFP.

While the right to purchase such options is open to anyone, the use by dairy farmers is best advised to be based upon actual production and sales volume.

In essence, it works this way: If the actual BFP is more than the anticipated BFP specified in the put option, the farmer sells his milk at the higher price and receives nothing for the put option.

The cost of buying the put option is to be incorporated as a business expense, such as purchasing insurance, and therefore can be deducted as a business expense.

The commission and premium are lost, but that amount is small compared to the protection that could be afforded.

If the actual BFP is well below the put option BFP, the farmer sells his milk, but then he also receives the cash from selling the put option, protecting cash flow.

The milk check still comes from the actual buyer of the milk. The options check comes from the commodity trading house.

During the meeting it was made clear that those selling such put options and those trading BFP futures contracts are for the most part shrewd and savy about dairy prices and trends and industry influences.

The trading houses attatch premiums on the options, depending upon the amount of risk.

A put option premium is attatched to a range of BFP possible prices available for purchase, in 25-cent increments.

For example, if March BFP futures were trading at $13.50, a DOPP-participating farmer could have purchased a put option on a range of possible BFP prices below $13.50.

(This is only through cost-sharing available through the DOPP. In reality, a farmer could purchase a higher put option, but this government program is designed for protections against steep drops in BFP, not for profit.)

The DOPP program is designed to allow farmers to set their own price floor, starting at 25 cents below the future option BFP and going down in 25-cent increments. (The lower the floor, the less the premium.)

Holzhauer talked about his personnal experiences and provided his thoughts on the use of the put options as a useable tool.

In brief, he said that the tool is useful, but not all the time. It should be used strategically, instead of automatically, he said.

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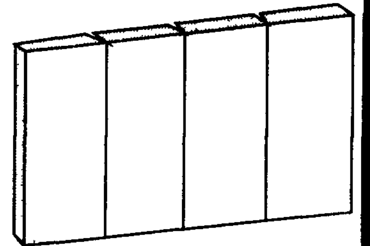

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